BE CAREFUL WHAT YOU WISH FOR ...

IF THE RED INK PARTS

BY HARRIS COLLINGWOOD

PLUS:

ARTICLES BY JAMES FALLOWS
AND RONALD BROWNSTEIN

SO, DO DEFICITS MATTER?

BY KIRSTIN DOWNEY
ALLSTATE BELIEVES that there are no challenges we cannot meet if all Americans work together, if we listen to each other, and if we compromise for the common good. But no one can stay on the sidelines. Everyone must take ownership and provide leadership in these challenging times. Major corporations are no exception.

That’s why Allstate commissioned a survey aimed at bridging the gap between Main Street and Pennsylvania Avenue. Our goal is to show how ordinary Americans are navigating this very demanding economy and to demonstrate the great pragmatism and optimism that lie at the heart of the American people.

As a company that is in the business of helping American families better manage their risks and create more secure economic futures, Allstate wants to shape the kind of change and innovation that will help people survive and thrive in today’s unpredictable world.

A SURVEY of MIDDLE-CLASS AMERICANS

The Voice of Our Nation comes from the Heart of Our People

64% OF AMERICANS feel they face more economic risks today than their parents faced at the same age.

CONFIDENCE IS DROPPING

According to survey findings, confidence in several major institutions has dropped off from 12 months ago.

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<th>Institution</th>
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<td>Elected Officials in Washington, D.C.</td>
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<td>Major Corporations</td>
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<td>The American Consumer</td>
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<td>31%</td>
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Believe that owning a home helps, rather than prevents, living the American Dream.

Made significant reductions in spending, including putting off major purchases 48%
Withdrew money from savings or pension funds to make ends meet 32%
Lost a job or been unemployed for a sustained period 31%
Reduced contributions to a 401(k) or other pension/retirement fund 27%
Not experienced any significant changes in lifestyle or financial security 23%
Gone without health insurance for a sustained period 22%
Fallen behind on paying mortgage or rent 14%

Most Millennials would prefer to work for a single employer for many years.

Prefer long-term employment with a single employer 55%
Prefer the opportunity to change employers/professions 34%
Don’t know 11%

The American Dream

73% believe that owning a home helps, rather than prevents, living the American Dream.

Americans Want Action on Jobs

Support tax incentives for businesses to hire more workers 52%
Say government should play an active role in the economy 61%

Renewed Optimism

2/3 of Americans (69%) say they’re optimistic that the United States can successfully grow its manufacturing industry to remain the international leader.

Moving Forward

When asked to choose the most important factor in determining a person’s ability to get ahead, Americans cite Education most often (39%), followed by the state of the Economy (23%), a person’s own Skills (22%), and a person’s Income level (9%).

For more survey findings, visit www.allstate.com/heartland-monitor.

Source: Allstate/National Journal Heartland Monitor Poll
America’s voice is our guide to the future.

The recent economic crisis brought enormous disruptions for virtually every demographic group and institution in America. Millions who'd built their lives around the pursuit of the American Dream faced – for the first time – the fear that the dream might be unachievable.

At Allstate, we are in the business of helping Americans better manage their risks and create more secure futures. We’re committed to fostering the kind of change, innovation and progress that will allow people to thrive in today’s unpredictable world.

That’s why in 2009 Allstate commissioned a polling series – The Allstate National Journal Heartland Monitor. This research is aimed at understanding what many Americans are experiencing in their daily lives, identifying potential solutions to the challenges they face and driving change. At its core, this poll series has brought forth the great pragmatism and optimism that live within the American people.

Approaching its tenth installment, The Allstate National Journal Heartland Monitor continues to explore and probe relevant topics and gives us important insight into the beliefs and attitudes of Americans.

As we listen to the voice of our nation, we have come to better understand the heart of our people:

- The things that make up the American Dream – home ownership, job security, college affordability, access to health care and a safe retirement – are less accessible and more insecure than at any time in 70 years, causing our country’s core beliefs to be severely shaken.

- Americans want a new approach to leadership among elected officials, private citizens and corporate leaders. They want it centered on greater collaboration rather than corporate or political goals.

- People don’t trust our major institutions – government or business.

Yet there is good news, even great news:

- Throughout our surveys, people have consistently said they think the country is headed in the wrong direction. Yet they remain optimistic that our nation’s best days are ahead of us, with 87 percent saying that America is still the land of opportunity.

At Allstate there are no challenges we cannot meet when we all work together, when we listen to each other, and when we compromise for the common good. The same is true for our country.

If you’d like to learn more about the Heartland Monitor series and hear the voice of our people, please visit www.allstate.com/heartland-monitor.

Joan H. Walker
Executive Vice President of Corporate Relations

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Fall 2011

The Next Economy

A special supplement and joint project of The Atlantic and National Journal

From the Editors

Everyone knows that debt is a sin. The Bible says so (Matthew 6:12: “And forgive us our debts, as we forgive our debtors”). Debtors used to go to prison; now they lose their credit and their homes. Ever since the proliferation of shoddy mortgages helped touch off the Great Recession, consumers and governments both here and abroad have been scrambling to shed their debt. An act of virtue, any moral philosopher would tell you. But what if everybody did it? Simultaneously?

Be careful what you wish for.

This edition of The Next Economy, produced jointly by The Atlantic and National Journal, is all about debt. The subject couldn’t be timelier, as Washington’s anguish over controlling the federal deficit will provide a context for the election year to come. That’s what we have tried to do here—provide a context. The articles inside take a deeper look at debt, far into the past and into the future. Are we in over our heads? What’ll happen if we are? The answers may surprise you.

The cover story explores what a deleveraged America might look like. Ugly, more likely than not. If consumers do the right thing and government does the same, as Harris Collingwood learns, we can expect subpar growth, more unemployment, and a national psychology to match. And yet we can’t keep doing what we’ve done. As Harvard economist Kenneth Rogoff argues on p. 21, it’s the overhang of debt, private and public, that has kept the economy in the ditch.

Yes, the proliferation of debt in every sector of the economy is frighteningly obvious from the graphics on pp. 14-15. But debt isn’t always a terrible thing. It depends, Kirstin Downey concludes in an eye-opening sweep through history, on how the borrowed money is spent. When ancient Romans and modern Americans built roads, the investment paid off; when Spain and Byzantium exhausted their treasuries, their empires fell. In the United States, the federal government has always been in debt except for a year or two in the mid-1830s. Yet only when it symbolizes a government out of control, Ronald Brownstein finds, has the electorate risen up in disgust.

So, how much danger are we in? Need we fear that China holds too much of our debt? Not really, James Fallows reports. Still, the notion of debt as an evil persists—and ought to, for our individual sakes. Alina Tugend tells us how to get out of debt and stay out. Even if what’s good for each of us isn’t good for all of us.

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HEATHER ANDERSON ruefully admits that she should have known better. A veteran of nearly two decades in the credit-union industry, she had spent her career warning would-be borrowers about the perils lurking in home-equity loans, bells-and-whistles mortgages, and the seductive fantasy that debt was interchangeable with wealth. But the housing boom was roaring ahead, and “I started to feel left out,” Anderson recalled. So in 2005, she and her boyfriend bought a house in San Diego with a no-money-down, interest-only mortgage and a home-equity loan.

Less than a year after the couple moved in, they broke up. Unable to sell the house, even at a loss, and ground down by the strain of living with her ex, Anderson moved out, although she kept up her share of the mortgage payments. “I had to,” she said. “My credit score was my safety.” But her sacrifice was in vain. Her former boyfriend moved out as well, leaving no forwarding address for the mortgage company. Unable to persuade her lender to renegotiate, Anderson, now 41, watched helplessly as the house slipped into foreclosure, dragging her credit score down with it. When the interest rate on her sole credit card jumped 50 percent in a month, she started paying for all her purchases in cash.

What followed took Anderson by surprise. Instead of the unrelenting anxiety she expected as her income and credit rating went into a free fall, she felt relieved. It wasn’t just that she no longer worried about scraping together enough cash to pay the monthly mortgage. It wasn’t only the satisfaction she felt as her credit-card balance went into remission. It was the serenity she felt after she unplugged from the consumption economy’s machinery of desire. Anderson had canceled her cable-television subscription after moving out of her house, and, without the constant din of commercials hawking the next must-have kitchen gadget and the fashion tips that left her itching to update her wardrobe, she found herself with ample time to launch a sports-jersey business—financed without credit, of course. No longer tempted to roam the mall in a fog of hankering, Anderson felt a newfound clarity about what really mattered in life. “Instead of consuming in my spare time,” she said, “I started producing.”

Millions of Americans are taking similar steps. Some 8 million U.S. consumers stopped using bank-issued credit cards in 2010, according to the credit-reporting agency TransUnion.
The average credit-card balance has fallen 10 percent this year from 2010, to $6,472; U.S. consumer debt has dropped for 12 consecutive quarters, from a peak of $14 trillion in early 2008 to $13.3 trillion last spring, mainly because of mortgages repudiated or abandoned. People are cutting visits to the hairdresser, buying used cars without financing, and living on surplus cheese as they trudge toward the promised land of a debt-free existence.

Suppose everyone did what Heather Anderson is doing? And that the federal government, just as virtuously, did the same? And Europe too? What if everyone deleveraged at once? Guess what—that is exactly what's happening in the wake of the Great Recession. For better or worse.

Probably worse.

Ponder what economists call the paradox of deleveraging. This occurs when economic actors on all sides—consumers, business, government—all retire their debts at once. Unless their incomes are rising, they can pay off debt only by cutting what they spend. This, in turn, reduces the demand for goods and services, which drives prices down, further trimming businesses’ revenue and thus their ability to pay employees, who in consequence spend less. The cycle continues, until incomes fall so low that there's no longer cash available to reduce the debt. And as incomes and business profits decline, so do government tax receipts, resulting in fewer police officers, more unfilled potholes, and greater pressure on pensioners.

A deleveraging nation, economists say, risks higher unemployment and years of subpar economic growth and could trigger a deflationary spiral in which consumers forgo spending, anticipating lower prices in the future. “When economies are deleveraging,” Atlanta Federal Reserve Bank President Dennis Lockhart said in a recent speech, “they cannot grow as rapidly as they might otherwise.”

Ye gods, what to do?

Economists offer two (or more) contradictory answers. Keynesians believe that government can break the downward spiral by borrowing money and injecting it into the economy, replacing the income lost when jobs disappear and consumers don’t spend as before. The government-driven uptick in
demand, the thinking goes, instills confidence that economic activity will pick up, spurring hiring and giving consumers the means to spend while paying down their debt. Once the economy starts to grow faster than the government’s borrowing, the debt will decline as a percentage of economic output.

Ain’t gonna happen, even if the Keynesians are correct. Not in the current political environment—and not only in the United States. All over Europe, austerity has broken out, as governments rein in borrowing, raise taxes, and cut payrolls and pensions—while their economies stall or even shrink.

Let’s hope, then, that the conservative economists are right about a deleveraged nation and its ultimate rewards. They see government spending as only a short-run “sugar high” that extracts two intolerably high costs in return. One is that investors, worried about the government’s ability to repay the additional debt, will drive up interest rates. The other: Business owners, spooked by the higher taxes to come, will pull in their horns. “There’s tremendous uncertainty about what government is going to do to meet its liabilities,” George Mason University economist Richard Wagner said. “So businesses hesitate to invest.”

But in the long run, these economists say, the short-run pain will give way to long-term gain. If the government stops soaking up most of the available credit, “that frees up money that business can use to hire and invest,” Wagner said. Similarly, he said, if working people know that future Medicare and Social Security payments will decline, they’ll have more incentive to work hard and save for the future.

Not that this age-old debate between Keynesians and conservatives will ever truly be settled. All those graphs in economics—of supply and demand, etc.—rely on assumptions about mass psychology, about how consumers, employers, and workers will react in particular circumstances. And who can ever feel sure about that?

THE MESS WE’RE IN

Such is the bind in which the United States finds itself, three years after the world financial system nearly collapsed amid the collective realization that governments, businesses, and households had all borrowed far more than they could possibly repay—far more, in fact, than there was collateral to secure it.

The federal government led the way. Its debt swelled from $907 billion in 1980 to $14.7 trillion in September 2011. The rise wasn’t slow or steady. Powered by tax cuts plus two wars and a Medicare prescription-drug benefit, all financed by borrowing, the debt rocketed during George W. Bush’s administration, from $5.7 trillion in 2001 to $10.7 trillion. Under President Obama, the federal debt has soared by another two-fifths, mainly because of the debt-financed public spending that was meant to stabilize the economy after the 2008 meltdown.

Until recently, consumers borrowed almost as avidly. As lenders crafted credit products for borrowers of every need, consumer debt exploded after 1980. The largest increases came from 2000 to ‘07, when total household borrowing more than doubled—to $13.8 trillion, mostly for mortgage debt—while consumer prices rose by only one-fifth. Consumers, some economists say, were trying to compensate for stagnant incomes, which gained by only a tenth on average (adjusted for inflation) from 1973 to 2010. Business joined in, especially in housing-related industries, borrowing half again as much in 2007 as in 2000. Small businesses availed themselves of cheap money.

All this debt was more than the system could stand. Housing’s perpetual-profit machine worked only as long as homebuyers and their lenders believed that housing prices would continue to rise. When their confidence cracked in 2007, amid rising payment delinquencies and defaults, the entire mortgage edifice collapsed. Wall Street, which had benefited mightily from the bubble, imploded too.

The contraction since 2008 has been as sharp as the boom. As the cracks in the mortgage market widened, consumer borrowing fell off a cliff, falling by $1.1 trillion from 2007 to 2009. The financial sector, meanwhile, has unloaded $3 trillion in debt. Only the federal government increased its borrowing, from $237 billion in 2007 to an astonishing $1.24 trillion in 2008, then to $1.58 trillion last year.

Much of the deleveraging has been involuntary. Small businesses, even profitable ones with good prospects, have found it hard to get loans. (See sidebar, p. 12.) Although overall corporate borrowing began to rebound in late 2010, much of the increase was spent on investment—and jobs—beyond U.S. borders, especially in the faster-growing economies of Asia and Latin America.

Mortgage lending remains crippled, despite record-low rates and relatively low housing prices in much of the country, because lenders have tightened their borrowing standards. Applications for new mortgages this summer fell to a 15-year low, and four-fifths of those were to refinance. The average household’s debt, counting mortgages and credit cards, now stands at 114.6 percent of disposable income. That’s a dramatic decline from its peak of 130 percent in 2008, but still far higher than the 84 percent that prevailed in the 1990s.

Maybe more consequential in predicting the nation’s economic course, consumers’ deleveraging has increasingly been voluntary. They’re not exactly beating down the doors of their local bank for loans. In a reversal from the

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**Federal Deficits Since 1940**

Annual government deficits have reached levels not seen since World War II.

**Federal budget surpluses and deficits as a share of GDP**

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*Estimated. Source: Office of Management and Budget
not-so-distant past, households aren’t merely refusing to take on more debt; they’re using money they once spent to acquire more stuff to instead reduce what they owe. Moody’s Analytics found last spring that consumers used credit to stretch their purchasing power by $330 billion from 2000 to ’07 but, since then, have devoted $150 billion of it to paying down debt. That $480 billion turnaround might presage the kind of aversion to debt that the Great Depression instilled in a generation of its survivors.

**WHEN BORROWING STOPS**

And what if it does? Although consumers may not have kicked the borrowing habit for good, they give every indication that they’re ready for a hiatus. And when consumers turn frugal, the entire economy shudders. A 1-percentage-point rise in the personal-savings rate works out to $100 billion in foregone spending, consulting firm McKinsey & Co. has calculated. That’s bad news to makers of brand-name household goods, such as Procter & Gamble, which have lost sales to cheaper store brands. Carmakers also get dinged, because consumers stick with their old wheels longer, according to automotive researcher R.L. Polk & Co.

All too often, lower living standards follow close behind. That isn’t the case for households whose incomes are rising, because they can pay down their debt while maintaining their accustomed level of consumption. But the millions of families who borrowed to supplement stagnant or shrinking incomes must choose between spending and reducing their debt. If they keep paying down debt, they’ll postpone visits to the doctor, take fewer vacations, and wear the same clothes for another year: “In an idealized economic model,” Wesleyan University economist Bill Craighead said, “interest rates, prices, and wages can adjust downward in such a way that demand remains steady enough to sustain economic activity.” But in the real world, those adjustments don’t happen immediately. Incomes fall faster than prices, and consumers, businesses, and government all tighten up on spending. “Without demand, there’s no growth,” he said, “and if there’s no growth, living standards have to slip.”

There’s an upside to consumers leaving their credit cards in their wallets, however. Because so many consumer goods are imported, the U.S. trade deficit falls, as Americans take a pass on Korean widescreen TVs and Malaysian jeans: In July, it dropped by 13 percent to $45 billion, the federal government reported.

What remains to be seen is whether consumers’ frugality will last beyond the current downturn. “Consumption is part of our DNA,” said Jenny Darroch, a marketing professor at Claremont Graduate University in California. But consumers lose the urge to whip out the plastic, Darroch suggested, when they learn that Bank of America plans to lay off 30,000 and the U.S. Postal Service may dismiss 120,000 workers.

**WASHINGTON’S QUANDARY**

If consumers keep shedding their debt while businesses continue to hold—or are held—back, that leaves only one economic actor with enough clout to funnel cash into business’s coffers and put people to work: the federal government. Or so the conventional—that is, Keynesian—textbooks say. Without government spending at a time of high unemployment and tight credit, Keynesian economists argue, business can’t create jobs and people can’t meet their expenses or pay down their debt. “Deficit reduction is the last thing we need to focus on,” University of Texas economist James Galbraith said.

No, it’s the first, counters Stanford University economist John Taylor, who worked for both Presidents Bush. Far from spurring private-sector demand, Obama’s debt-financed programs—cash-for-clunkers, first-time homebuyers’ tax credit, public-works spending—“lowered investment and consumption demand by increasing concern about the federal debt, another financial crisis, and threats of inflation or deflation,” he wrote in *The New York Times*. Only when the government demonstrates “a clear commitment to America’s living within its means,” he argued, “will business regain the confidence to hire, expand, and invest.”

Evidence in Taylor’s favor is that hundreds of billions of federal dollars haven’t restored a thriving economy, reassured business, or lowered unemployment much. In any case, given the prevailing political mood and the creation of a congressional super committee tasked with reducing the federal deficit, a slowdown in government borrowing seems inevitable. The conservatives’ theory that less government intervention means a healthier economy will be put to the test.

If they’re wrong, the consequences could be dire. In South Dakota and Michigan, some counties are replacing battered roads with gravel, because local governments can’t afford to repave them. Cuts in federal and state aid have forced cities and towns across the country to sharply curtail social services and to lay off police officers, firefighters, and teachers.

“These cuts are completely unnecessary and destructive,” Galbraith said. He called on governments to incur debt for undertakings that will pay dividends into the future—repairing roads and bridges, conducting research on alternative energy, and, above all, creating jobs.
AUSTERITY ABROAD

Does reducing the government’s footprint work as advertised? The experience abroad offers clues. In Europe, where public-debt cuts have been government policy for more than a year, the results don’t inspire confidence, at least so far.

Consider Greece. The debt-ridden country was saved from defaulting last year on its bonds when the European Union, the International Monetary Fund, and financial institutions supplied a $155 billion bailout in exchange for a strict timetable of spending cuts, tax increases, and sales of government-held assets. But so far, Greece’s deleveraging has backfired. The Finance Ministry predicts that the economy might shrink by as much as 5.3 percent in 2011, depressing the tax receipts that the country needs to repair its finances. And its debt is a bigger problem than ever. With its creditors unable to agree on bailout terms, many investors expect Greece to default on its loans.

The rest of Europe’s economies have performed better, but not by much. In Britain, more akin to the United States, the Conservative-led government’s austerity program hasn’t revived the economy. The Institute for Fiscal Studies, a respected London think tank, predicted recently that British living standards will decline by 10 percent over three years, with price increases far outstripping the growth in incomes.

Most other European governments, though less in debt than Greece, have imposed austerity measures of their own. Growth in the 17 countries that use the euro

What Alexander Hamilton Saw as a Strength ...

By Ronald Brownstein

NDIANOLA, IOWA—THE RAIN varied only between pelting and torrential as Dick Pipho trudged through a muddy field at a tea party rally here on Labor Day weekend.

A retired venture capitalist and businessman from nearby Grimes, Pipho didn’t seem to mind the weather. He moved steadily through the crowd, carrying a clipboard to which he had affixed a succinct bumper sticker: “Debt is our greatest threat.” The clipboard held a pledge committing everyone who signed it to vote in 2012 only for a presidential candidate who presents a plan to balance the federal budget by 2017 and to begin paying off the government’s debt—roughly $10 trillion, not counting what the government owes to itself—by 2018.

Even amid the recurring downpours that drenched the crowd waiting for headliner Sarah Palin, Pipho did a brisk business. He estimated that he had already filled 12 sheets with signatures. “People are getting serious about our deficit and our debt,” he said. “China is going to come in and foreclose one of these days.”

Except for one or two years during the mid-1830s, the United States has carried a public debt every year since its founding. In fact, the debt preceded the nation: The Founders borrowed heavily from Europe to finance the Revolutionary War. Yet only rarely since then has the debt seized a central role in America’s politics. As the blurry signatures on Pipho’s waterlogged pledge sheets suggest, this is one of those times.

In the Republic’s early days, many citizens viewed the ability to carry and service a public debt as a source of national strength. Great Britain’s ability to borrow more effectively than its rivals, for instance, allowed it to finance a military establishment that vaulted it past all of its competitors in the 18th and 19th centuries. Alexander Hamilton, the first U.S. Treasury secretary, had that example partly in mind when he declared in 1781, “A national debt, if it is not excessive, will be to us a national blessing.”

Thomas Jefferson and the Democratic-Republican Party that he led never accepted that logic and paid down the debt during the first decade of the 19th century. Even so, the public debt didn’t become a major political issue until Andrew Jackson made it one in the 1820s. Jackson’s objection was less economic than ideological—and personal. His abhorrence of debt was rooted in a failed land deal of his own, and his contempt extended to paper money, most federal spending, and—above all—the Bank of the United States, a distant precursor of the Federal Reserve. He viewed all of these as the means by which the rich and powerful manipulated government to gain advantage over the nation’s small farmers and workers.

“At that point, the idea of the federal government living beyond its means meant that the rich and powerful were bilking the taxpayers,” said historian Sean Wilentz of Princeton University, who has written extensively on that era. As early as his (losing) 1824 presidential campaign, Jackson called the debt “a national curse” that served “a monied aristocracy,” historian John Steele Gordon recounted in Hamilton’s Blessing, a concise history of the federal government’s debt that provided key insights for this account. After Jackson won the White House in 1828, he proudly tracked progress toward extinguishing the debt in each of his State of the Union addresses. When it was finally paid off at the end of 1834, he triumphantly wrote: “Free from public debt, at peace with all the world ... the present may be hailed as the epoch in our history which shall be best calculated to give stability to our Republic and secure the blessings of freedom to our citizens.”

Ironically, Jackson’s maneuvers—particularly, his Javert-like quest to eliminate the central bank—produced a financial crash that sent the nation back into debt. The red ink became a torrent during the Civil War, whose costs demanded enormous borrowing, even after the first income tax was introduced. Validating Hamilton’s vision again, the Union’s superior ability to borrow contributed to its victory over the Confederacy.

During the next half-century, the federal debt declined steadily as a share of the economy without much fuss or discussion. Predictably, it rose again during World War I, though the government subjected more Americans to the income tax and raised its rates. The war’s aftermath produced the first big
A waning of optimism could reshape American politics—and not for the nicer.

round of debt politics since Jackson's day. Calvin Coolidge and his Treasury secretary, Andrew Mellon, placed reductions in the debt, spending, and taxes at the center of their economic vision—anticipating arguments that Ronald Reagan and then the tea party would offer decades later. “From a reduction of the debt and taxes will accrue a wider benefit to all the people of this country than from embarking on any new enterprise,” Coolidge insisted.

The Depression reversed Coolidge's progress against red ink, and the debt soared during World War II to its highest level ever as a share of the economy. Even after the necessity of borrowing to defeat Nazi Germany and Imperial Japan had passed, the debt provoked surprisingly little debate in the postwar years. That largely reflected the influence of British economist John Maynard Keynes, who believed that governments should try to manage the economy by running larger debts during slow times and smaller ones during fat years.

Over the next quarter-century, annual budget deficits became routine, but the debt declined anyway as a share of the economy because growth was generally so robust. The debt soared in the 1980s, measured against the overall economy, when Reagan sharply cut taxes, increased defense spending, and constrained domestic expenditures only to a limited degree. This generated some anxiety (and modest congressional steps to trim the deficit) but never a full-scale revolt. This was partly because tax cuts had supplanted deficit control as the top priority of many Republicans, but probably more because the economy was humming.

The recession that followed under George H.W. Bush provoked the most serious debt debates since Coolidge. Bush's 1990 budget deal took important steps to reduce the deficit, but the issue reached critical mass in the 1992 presidential race. The spark was Ross Perot, the quirky businessman who echoed Jacksonian arguments about the debt and insider influence; his independent campaign attracted nearly a fifth of the vote.

Partly inspired at first by Perot's success, Bill Clinton pushed two deficit-reduction packages through Congress that eventually combined with buoyant growth to produce repeated surpluses in the late 1990s. Federal Reserve Board Chairman Alan Greenspan even fretted in congressional testimony that the nation might pay off its debt too fast.

Greenspan, it turned out, had nothing to fear. After persuading Congress to cut taxes, George W. Bush launched wars in Afghanistan and Iraq and established a prescription-drug benefit for Medicare, all without establishing any offsetting source of revenue. Again, the deficit spiked. As in the 1980s, however, it never became a central point of political contention, in part because the GOP's priorities had shifted but also because the economy was fairly stable through the middle years of Bush's presidency. Grumbling about the debt became a roar only after it grew under Barack Obama—swelled both by the economic collapse of 2008 and the cost of his stimulus plan to combat it.

Much of today's heightened anxiety over the debt may be grounded simply in the sheer speed of its growth; the money the government has borrowed from domestic and foreign investors is on track to double between 2008 and 2012. “The public doesn't like sharply escalating debt,” noted Robert Bixby, executive director of the bipartisan Concord Coalition, which advocates fiscal discipline. “It really is symbolic of a government out of control.”

Especially during hard times, Americans forced to economize may understandably wonder why government doesn't do the same. Politics also plays a part: Conservative voters, who tend to get the most exercised about the debt, usually object more when a Democrat is in the White House.

What's new in 2011 is that, even to a greater extent than in the 1990s, the national debt has become for many Americans a symbol of national decline. Alexander Hamilton saw the debt as evidence of America's strength—it's ability to finance its rise by tapping its future wealth. Now, however, millions of Americans regard it as evidence of weakness—presenting the threat of an economic collapse like Greece's or of a dangerous vulnerability to nations such as China that hold our debt. Today's agitation over Hamilton's “national blessing” may be less a cause than an effect of deeper fears about whether America's best days have passed.

The author is the editorial director of National Journal.
at a crawl, and the stock market has yet to regain its earlier heights. Prime ministers and their governments have come and gone, none of them able to muster the will and vision to lift the economy from its doldrums. Sound familiar?

LOWER EXPECTATIONS

The impact of deleveraging in Japan has been more than economic. It has produced a generation of chronically discouraged young workers. When McKinsey & Co. surveyed Japanese ages 18 to 35 last year, only 10 percent deemed themselves ready to compete in the global economy; two-thirds of them doubted that their country could.

This gloom hasn’t spread to the United States—yet. The popular culture has remained relentlessly upbeat—comic-book escapism in the movies, nostalgia (à la Mad Men) on TV. A rare new series on this fall’s primetime schedule that will tackle the foreclosed futures of the young is, tellingly, a sitcom, CBS’s Two Broke Girls. “The tale of our times is mostly being told by our unwillingness to tell it,” cultural commentator Jaime O’Neill wrote in the Los Angeles Times.

Like the Depression-era movies that showed butlers in marble foyers, this avoidance suggests how much is at stake. It goes to the heart of American expectations that every generation will enjoy a higher standard of living than the one before it. This expectation isn’t dead yet, but it’s in danger. Fifty-five percent of respondents to a Gallup Poll last spring thought it unlikely that young people today will live better than their parents. An Associated Press poll found that more than half of 18- to 24-year-olds anticipate having a harder time buying a home and saving for retirement than their parents did.

Their pessimism may be warranted. Unemployment is one of the prices of a

### How the Surge in Consumer Lending ...

By Louis Hyman

New York—in 1991, Rob Kaufelt bought a little cheese shop in Greenwich Village. Like many other businesses on Cornelia Street at the time, Murray’s Cheese had sold lovingly crafted foods for years and years. Its future, like that of its neighbors, looked bleak. With all of the hand-wringing over cholesterol and before the Atkins diet, fancy cheese was no growth market. It certainly wasn’t a smart place to invest, though that is what Kaufelt did when he acquired Murray’s Cheese from its second owner.

Now it is a New York institution. Murray’s has been profitable every year since 1991; this year, it expects sales to reach $20 million. Forbes declared it the world’s best cheese shop. The nation’s largest grocery chain, Kroger’s, has even arranged to set up mini-Murrays in its hundreds of stores.

So why have some of the nation’s largest banks, sitting on piles of cash, turned Kaufelt down for loans to bolster his small business’s growth? Like most Americans, Kaufelt can borrow for a roof, a car, or a couch. But his profitable and stable business can’t.

Understanding the difference between a cheese shop and a home mortgage goes far to explain the underlying crisis in our credit system today.

Baby boomers are prone to doubt that their parents ever indulged in debt. Instead, they like to think that their Depression-era parents flourished in the 1950s by saving pennies. Lamenting the loss of a nobler generation’s virtue of thrift—in their own lives and in their children’s—baby boomers have tended to regard the Great Recession not only as a financial fiasco but also as a moral failure.

It’s all a myth. The Greatest Generation drove financed cars from mortgaged homes to department stores, where they charged their purchases and then deducted the interest from their taxes. In many ways, consumers’ incentives to borrow were even stronger then than they are today. What constrained borrowing after World War II wasn’t Americans’ thriftiness but, rather, banks’ unwillingness to lend money to consumers.

For the lender, every debt is an investment carrying a risk and a return. Today, as in the 1930s, the hard times have lingered in part because big banks’ fears about the economy have prompted them to sit on their cash. During the Depression, New Deal agencies such as the Federal Housing Administration and Fannie Mae reassured private investors that it was safe to put their money into mortgages by guaranteeing repayment of the loans if homeowners defaulted. Soon, banks diversified from mortgages into other forms of consumer lending. Bank of America, for instance, got involved with FHA mortgages in 1934 but, within a few years, also offered cash loans, car financing, and other forms of consumer lending.

From the 1930s through the 1960s, consumer borrowing remained limited to the capital that banks and investors had on hand. These limitations began to relax in the 1970s as lenders started to divert money from capital markets—traditionally devoted to business borrowing—to consumer loans. Mortgage-backed securities, first issued by Fannie Mae in 1970, pooled millions of dollars in mortgages, whose monthly repayments of principal and interest were channeled...
deleveraging economy, and young people are paying more than their share: The jobless rate among workers ages 16 to 24 is 18 percent—double the national average. Even the lucky ones who find work can expect that as long as deleveraging—or anything else—stifles growth and keeps the job market fearsome, they’ll earn less when they join the labor force, and they’ll have fewer opportunities to hop from job to job and from raise to raise. Lower starting salaries and limited mobility will blight their earning power for years to come. Yale University economist Lisa Kahn has found that people entering the workforce during an economic contraction earn about 10 percent less during the first 17 years of their working lives than those who start when there are jobs aplenty. What’s more, they tend to stay in each job longer, resulting in incremental wage gains instead of the jumps in salary that often accompany a new position.

Expect any waning of optimism to reshape American politics—and not for the nicer. A recent poll by the Pew Research Center for the People and the Press found Americans almost equally split over whether Washington, to speed the economic recovery, should spend more or cut the deficit. This ambivalence drove the summer’s toxic debate over the debt ceiling that further poisoned the tone of U.S. politics.

Deleveraging could also pit the young against their elders.

If older Americans, finding their retirement savings depleted, stay in their jobs longer and thereby block younger workers from advancing, resentment between the generations could erupt. So, too, if Washington curbs Social Security benefits or raises the age of eligibility. “We face the real possibility that this century will be marked by harsh generational conflicts over limited resources,” says David Yamada, director of the New Workplace Institute at Suffolk University Law School in Boston.

Or possibly young people will just learn that “life isn’t what you expected,” as Barry Schwartz, a psychology professor at Swarthmore College, put it. He sees a chance that Americans would emerge from a long and deep recession with a worldview like the one that prevailed before World War II, when people accepted straitened circumstances with the confidence that their children would fare better.

After the war, “that stopped being good enough,” Schwartz recounted. “Parents started to expect that their own lives would get better.” Fulfilling these expectations required a steady rise in incomes that only a thriving economy could provide. Lowering those expectations, after a half-century of seeing them rise, could get ugly indeed.

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... Has Squeezed Small Businesses Dry

So what did this mean for cheese? Even before the recession, small businesses were finding it tough to line up loans. In earlier decades, they could easily obtain a line of credit at the local bank, which had few other places to put its capital. With consumer loans surging and big corporations able to borrow as easily as ever, small businesses got squeezed out. While securitized loans to consumers looked easy, liquid, and low-risk, loans to small businesses were labor-intensive, illiquid, and risky—everything that lenders try to avoid. Unable to obtain a revolving line of credit to buy and sell more cheese, Murray’s Cheese—like so many other small businesses—has been forced to resort to its own profits to finance its growth, necessarily limiting how quickly it could expand. In some ways, Murray’s is lucky, for many owners finance new businesses nowadays on their credit cards.

“Zero interest rates won’t help American cheese mongers if they can’t get a loan,” Kaufelt said. In his mind, the financial world has failed small businesses, which account for nearly two-thirds of the economy’s new jobs. Even after the 2007 recession, according to the Securities Industry and Financial Markets Association, more money is invested in consumer debt ($10.4 trillion) this year than in corporate bonds ($7.6 trillion).

What if the financial stratagem that got us into this mess could help get us out? Here’s a thought: Securitize loans to small businesses like those to consumers, as a way to bolster the credit-starved employers that goose the common good. Bundling the debt of cheese shops with those of florists and contractors and T-shirt makers, then selling these as securities to investors, might draw capital away from dead-end consumer loans and into businesses that create jobs. As long as the economic growth thus generated exceeds the risk that Murray’s Cheese et al will fail, this would bring more tax revenue into governments that need every cent. Paradoxically, a solution to reducing the national debt may lie in making it easier for businesses to borrow.

The writer teaches economic history at Cornell University. He is the author of Debtor Nation: The History of America in Red Ink, published earlier this year, and of Borrow: The American Way of Debt, to be published next January.
Mountains of Debt

Outstanding debt in the U.S. economy has surpassed $52 trillion, which encompasses not only home mortgages and credit-card bills but also borrowing by government, businesses, and financiers. The expansion of credit since World War II raised living standards and transformed the U.S. economy into one driven by consumer spending. But too much of a good thing, in the form of overborrowing and easy credit, led to our current overload of debt. So much debt was accumulated over the past decade, and is still owed, that borrowers, lenders, and spenders have become reluctant to do business.

Financial business

Household

Nonfinancial business

Federal government

State/local government

Rest of world

How Debt Has Changed

A half-century ago, most debt was in the federal sector, which had run up huge deficits to fight WWII. As America shifted to a consumer economy, the private sector took on a growing share of total U.S. debt.

Financial debt grew as loans, including subprime mortgages, were packaged and sold to investors, who profited so long as the underlying loans were repaid.

Household-sector debt increased sharply after 1945 as mortgages and home-equity loans became common and credit cards proliferated.

Businesses borrow to support and expand their operations. As businesses grew, so did their appetite for credit.

Note: Federal debt shown here does not include intra-governmental debt, currently about $4.6 trillion. This is money that the government owes itself after having borrowed it from sources such as the Social Security Trust Fund.
On the eve of the Great Recession, financial and household-sector debt each equaled or exceeded gross domestic product.

Deleveraging has begun in the financial, business, and household sectors. Federal debt, which spiked as government spending rose in response to the financial crisis, remains high.

Federal debt, which once dwarfed everything else, reached a low of 11 percent in the early 2000s amid a booming economy and balanced budgets.

State and local government debt has shrunk to a smaller portion over the years; it has always been a small slice of the overall picture.

The rest of the world owes a tiny share of outstanding debt, mostly to U.S. holders of foreign government and corporate bonds.

Sources: Federal Reserve Board, Commerce Department

Graphic by PETER BELL, BRIAN McGILL, and RYAN MORRIS
So, Do Deficits Matter?

History teaches that public debt can lift a nation to prosperity or bring an empire to its knees. It depends on what the borrowed money is spent on.

By KIRSTIN DOWNEY

In political Washington, a rare consensus has been reached: Federal budget deficits pose the direst danger to the U.S. economy. The summer’s agony over striking a deal to raise the debt ceiling and the creation of a congressional super committee to whittle down the federal deficit have turned on its head the axiom that then-Vice President Dick Cheney reportedly propounded as recently as 2002: “[President] Reagan proved that deficits don’t matter.”

Americans, by and large, agree with Cheney. According to opinion polls, the public worries more about the loss of jobs than about mounting deficits. Nor has business stormed the ramps because of the imbalance in federal revenue and spending. More than half of the entrepreneurs in a recent Harris Interactive poll cited “economic uncertainty” as a major obstacle to hiring; they regarded the federal deficit and debt as a source of that uncertainty but not as any immediate threat to their businesses. Even economists are of varying minds, depending on their political persuasion, about the significance of deficits to a nation’s well-being.

Let’s consider, then, another means of judging whether deficits matter: the dispassionate lessons of history. What do they teach? That sometimes, a public deficit lifts a nation to prosperity and strength; at other times, it can bring an empire to its knees. At first glance, the historical record looks chaotic. The Byzantine Emperor Justinian the Great inherited a full treasury but exhausted it on military campaigns and elaborate buildings—notably, the grand cathedral Hagia Sophia in
what is now Istanbul—and left a weakened state to his successors. Germany’s Weimar Republic, unwilling to cover its deficits with taxes or loans, printed more money instead; this brought hyperinflation (200,000 marks for a loaf of bread) and undermined its legitimacy, fostering the rise of the Nazis. In fighting the resulting war, President Franklin D. Roosevelt presided over a surge in the American government’s debt to 115 percent of gross domestic product. But this didn’t stop the United States from revealing in a postwar era of unprecedented prosperity.

Deficit-ridden nations have variously prospered, muddled through, or disintegrated, seemingly with no obvious pattern. Yet as the historical examples accumulate, patterns do emerge. Public deficits aren’t always bad or always good. A lot depends on the circumstances and, especially, on the purposes to which the government puts deficit spending.

**THE GOOD DEFICITS**

Public deficits may be incurred, economic historians say, for any of four purposes: to help invest in a nation’s long-term prosperity; to merely keep pace with an economy’s growth; to sustain pleasing but unproductive “prestige” programs, such as social undertakings and foreign adventures; or, worst, to cater to social dysfunction such as by letting the moneyed classes exempt themselves from taxation.

Spending on long-term investments, even if it exceeds a government’s income, is the likeliest to prove beneficial—or at least benign—to the society’s future. The Louisiana Purchase, for instance: Thomas Jefferson’s 1803 acquisition doubled the size of the country and acquired all or part of 15 future states. The U.S. government paid France $3 million in gold but financed the other $12 million by selling bonds. Tangible, productive assets, bought for 3 cents an acre, proved a wise investment even though it added to the public debt.

Going into debt to build infrastructure can also add value. In ancient Rome, the vast expansion of the roads into a network of 29 highways facilitated trade and technological progress across Europe for the next millennium; it helped Rome keep its economic vitality long after its system of interstate highways, championed by President Eisenhower in the 1950s, which fostered commercial development from coast to coast and ushered in benefits far exceeding its costs. This is China’s strategy now, as it speedily builds a high-speed rail system meant to link the huge nation’s disparate regions and reduce its dependence on oil.

Short-term deficits incurred in hard times have also been useful in bolstering economic vigor and protecting jobs. That was FDR’s strategy for easing the Great Depression, although it didn’t work as well as going to war. If the demand for products shrinks, government spending can pick up some of the slack until the private sector recovers—a Keynesian net that has lately become the object of partisan debate. A recent working paper for the International Monetary Fund examined the experiences of 17 industrialized nations from 1978 to 2009 and concluded that reducing the deficit in demand-constrained times, whether by cuts in spending or increases in taxes, had damaged the economy. Paring the deficit by 1 percent of GDP, the researchers suggested, reduced private consumption for the following two years by 0.75 percent and cut the inflation-adjusted GDP by 0.62 percent.

Indulging in deficit spending to fight a war can also act as an investment if it enhances the nation’s position in the postwar world. The United States benefited from World War II in two ways. Not only did new armaments plants add to its manufacturing base, but America emerged from the war as the only major country whose industrial infrastructure was undamaged. By 1950, the United States was responsible for more than half of the world’s economic production—and therefore had the loudest voice in organizing the international trade and monetary systems. All of this contributed to Americans’ astonishing prosperity during subsequent decades.

Other circumstances may produce deficits that don’t much matter either way; they’re neither all that beneficial nor particularly worrisome. The public debt may increase, but no faster than inflation or GDP or population—and thus no faster than the society’s ability to pay interest and repay the principal. From 1985 to 2007, for example, the U.S. public debt remained in the range of 40 to 60 percent of GDP without producing serious economic problems while encompassing periods of prosperity.

But even so, if a nation’s public debt increases relative to those benchmarks, at some point the risk to its economy grows. Economists differ on exactly where that point is, but they agree that it exists. Kenneth Rogoff of Harvard and Carmen Reinhart of the Peterson Institute for International Economics put it at 90 percent of GDP, a level that the Congressional Budget Office predicts the United States could reach in 2018. (See interview with Rogoff, p. 21.) In Japan, the public debt amounts to 225 percent of GDP, and—while cause and effect is hard to prove—the once-mighty economy has lost much of its dynamism.

Deficits are especially harmful to a nation’s economic health if incurred for showy but unproductive purposes. Consider the Aztecs of a half-millennium ago in what is now Mexico. They went relentlessly to war in pursuit of victims for their impressive displays of human sacrifice. The hate that this stirred up caused adjacent tribes to treat the invading Spaniards not as conquerors but as liberators. End of Aztecs.
WEALTH, FRITTERED AWAY

A classic example of an unproductive reason to incur mountains of debt is military spending. A country besieged by enemies has no choice. But for a country that isn’t, this sort of spending all too often brings on distant expeditions, unnecessary wars, inessential alliances, and glorious ventures of colonialism with precious little benefit to the colonizer.

Think of Spain. It ruled the world in the 16th and 17th centuries and, at first, its empire expanded rapidly and profitably. After Christopher Columbus claimed new lands for the Spanish flag, a friendly pope confirmed Spain’s right to its discoveries in the New World, and exploration brought forth gushers of silver and gold. The wealth arrived in Spain so effortlessly that the nation’s rulers bought whatever they needed from somebody else and invested little in their own country’s productive might. Forests were chopped down to construct fighting ships and galleons; the royal encouragement for raising sheep produced quick profits, but the grazing meant the loss of greenery down to its roots.

Then, almost all of this new wealth was frittered away. Taking on the role of defender of the Catholic faith, Spain battled tirelessly against the Protestants of Northern Europe and supported the Holy Roman Empire. With more reason, it fought the encroaching Ottoman Turks in the East. Eventually, this habit of military expenditure became too entrenched, at an unaffordable price. Financing the Spanish Armada alone cost 10 million gold ducats, more than the king’s annual income. Without a commercial economy to fall back on, Spain entered a period of decline, the victim of its own wealth and unproductive spending.

Americans, take note: Spain lavished much of its resources on attempts to impose a particular philosophy—Catholicism—on a part of the world that had rejected it. Since World War II, the United States has spent uncounted trillions of dollars trying to export democracy and capitalism worldwide. In Japan and Eastern Europe, maybe in Russia, these Western ways have taken root. In Africa, parts of Asia, and the Middle East, however, the local cultures have been far less receptive, despite American-led wars costing an estimated $4 trillion.

It is not always obvious, of course, whether a particular piece of a budget deficit ought to be counted as an investment or a waste—hence the current battle lines in Washington politics. Spending on health care, child welfare, and education is on the chopping block. Republican advocates of smaller government see these programs as a poor use of a country’s resources. Democrats tend to view them as investments in a healthy and educated workforce, so that workers can feel free to change jobs and to move wherever the labor market beckons.

THE KINDNESS OF STRANGERS

Or consider the deficits caused by a persistent shortage of revenue because the powerful have exempted themselves from taxation. It has always been thus. In the Gospel of St. Matthew, Jesus inquires of his disciple Peter: “From whom do the kings of the earth receive toll or tribute? From their children, or from strangers?” Peter said to him, “From strangers.”

Throughout history, the unwillingness of the wealthy and powerful to pay taxes has often marked societies in trouble. As the Roman Empire was waning, the Emperor Diocletian exempted the senators’ landed estates from taxation. A similar forgiveness happened as the Han Dynasty in China was nearing its end. Late in the Byzantine Empire, the influential monasteries were mostly exempted from taxation, prompting emperors to contest the founding of new monasteries and to block existing ones from acquiring more land. Around 1500 in Spain, the nobility made up 1.5 percent of the population and controlled 97 percent of the land—but paid no taxes.

Letting the wealthy escape taxation can cause turmoil, both financial and social. For one thing, it places the financial burden on everyone else. “My friends and I have been coddled long enough by a billionaire-friendly Congress,” financier Warren E. Buffett recently wrote in The New York Times, calling on Washington “to get serious about shared sacrifice.” The fear is that the non-wealthy will feel put upon and less loyal to the state and, as a result, less willing to defend it. Check online reactions to news stories and see how often respondents decry the legislative and tax systems as rigged by—and for—the powers-that-be. In the United States, the rage has been confined to the blogosphere; in London, young people have taken it into the streets.

French historian Alexis de Tocqueville saw the biggest threat to American democracy arising from the possibility that the most affluent members of society might seize control of the political and economic system to ensure their privileged position. The debate over the federal deficit might offer such an opportunity. “If ever again permanent inequality of conditions and aristocracy make their way into the world,” de Tocqueville wrote, “it will have been by that door that they entered.”

The writer is the managing editor of FTC Watch and the author of The Woman Behind the New Deal: The Life and Legacy of Frances Perkins. She is working on a biography of Queen Isabella.
A How-Not-To on Debt

The first rule for living life in the black is: Don’t spend more than you earn. Easier said than done.

By ALINA TUGEND

About 10 years ago, Joe Paretta, an English professor at Lafayette College in Pennsylvania, found himself about $12,000 in debt on his credit cards. He hadn’t lost his job or bought a new house or faced a health crisis. But little by little, over about four years, he had built up a debt that was out of control.

“I wasn’t making a lot of money, but I was irresponsible,” said Paretta, 44, who used his unhappy experience to write a how-not-to book, Master the Card. “I was using a credit card habitually, and when I got the bill at the end of the month, a lot of times I didn’t even remember what I had bought. I was making minimal payments, and I was satisfied.”

Until he wasn’t.

He got no wake-up call, nor did he hit bottom. Rather, Paretta said, “I felt like I was the middleman with my own money. I was getting my paycheck and paying the credit-card company.” So he decided to change things. First, he figured out “to the penny” what he owed. He started paying down his debt, which took about five years. When he got married, he helped his wife reduce hers. Now he has no outstanding balance on his credit cards.

Mortgages, home-equity loans, credit-card debt, and student loans—these all pile up. According to Consumer Reports, credit-card users shouldered a median debt of $3,793 last year. College graduates in 2009 who borrowed money for school owed an average of $24,000, according to the Project on Student Debt at the Institute for College Access & Success. And that understates their debt load, because it doesn’t count the loans that their parents took out.

Mortgages—way too easy—along with persistently low savings rates meant that many American households were regularly spending more money than they earned. What’s the solution? Paying down debt, unfortunately, is a lot like losing weight. It isn’t fun, and it means making some daunting choices. “Cutting back is inconsistent with popular American culture,” said Barbara Dafoe Whitehead, director of the John Templeton Center for Thrift and Generosity at the nonprofit Institute for American Values.

The initial step is often the toughest: taking a hard look at the numbers and figuring out where the money goes. “Surprisingly few people do that in any systematic way,” Whitehead acknowledged—including herself. “I try to save receipts and look at everything, but then I rationalize that I’m too busy.”

Next is the biggie: Don’t spend money you don’t have.
This is Mary Hunt’s No. 1 rule. Hunt, who runs the website DebtProofLiving.com, is the author of a forthcoming book 7 Money Rules for Life. Her advice: Don’t put something on your credit card unless you know you have the money in the bank. This simply isn’t how most people think, she said, but unless you spend less than you earn, rules “Nos. 2 through 6 won’t help.”

No. 2: Save 10 percent of everything you earn.

No. 3: Give some money to charity. This helps to check your sense of entitlement, Hunt said, reminding you that what you think of as needs are usually wants.

No. 4: Anticipate your expenses. “You may spend less than you earned,” she pointed out, “but Christmas is coming, and you didn’t save a dime for it.”

No. 5: Tell the money where to go. Don’t let friends influence you to shell out $150 on a Friday night—which adds up to $600 a month.

No. 6: Watch your credit score and protect it. A low credit score, Hunt cautions, can cost you $100,000 over a lifetime in higher insurance rates, mortgages, and car loans. Some employers even look at credit scores in deciding whom to hire, she said, because “they don’t want someone who can’t manage their money.”

No. 7: Never borrow more than you know you can repay.

Hunt also offers rules of thumb on borrowing. For starters, she advises, never take out an auto loan that lasts longer than three years. That’s when cars typically start to need repairs, so you would be paying for your car and for fixing it simultaneously.

Of course, for some people—especially the unemployed and underemployed—simply cutting back won’t be enough. No matter how carefully they budget, their debts will overwhelm them. In that sort of fix, Paretta suggested, “you should contact your credit-card company and tell them your situation and see if they can work with you.” At a minimum, negotiate for a lower interest rate.

“But people need to be honest,” he added. “Some people say they can’t [reduce their debt], but it’s that they’re not willing to do this. They’re not willing to change a lifestyle, at least temporarily, to get things under control.”

Not all debt, however, feels like a burden. Rachel Dwyer, an assistant professor of sociology at Ohio State University, distributed questionnaires to about 3,000 Americans ages 18 to 27; she found that those who owed on student loans generally said they felt greater self-esteem and more in control of their lives than those without loan debt did.

It’s counterintuitive, perhaps, and Dwyer acknowledged the researchers’ surprise at the finding. “But if you look at it not as the debt itself but as the trade-off of [getting] a college education,” she explained, “it makes sense.” Students may view education loans as money invested in their future. And, indeed, the poorer the student, the greater the boost in self-esteem. Students whose family incomes ranked nationally in the bottom 75 percent typically reported a greater jolt of self-esteem from taking out loans than wealthier students did. Dwyer figures that students from lower- and middle-class families, in greater need of money for college, may feel empowered by the ability to borrow.

Or—a darker interpretation—maybe students with loans are merely shortsighted, apt to focus on the education they’re getting right now while ignoring the fact that it’s money they’ll eventually have to pay back. This interpretation is supported, Dwyer said, by the study’s finding that having student-loan debt did nothing to enhance the self-regard of members of the next-older cohort, ages 28 to 34, who are likely in the throes of repaying it.

Americans’ devotion to debt has been paralleled—and aggravated—by their lack of interest in saving.

Americans’ devotion to debt has been paralleled—and aggravated—by their lack of interest in saving.

Until the 1980s, people typically put their savings into bank accounts. But in the following decades, such a conservative approach to investment was seen as foolish or underleveraged—“a 19th-century idea,” Whitehead said. Better, it was thought, to put your money into booming stocks or rapidly appreciating housing. The Great Recession showed the folly of such thinking. But the lesson came too late, because the bust left people with very little cash to fall back on. In 2010, 27 percent of American workers reported having less than $1,000 in savings of any kind, “and that includes retirement,” she noted—up from 20 percent just a year earlier.

Americans’ tendency to borrow more and save less than people in other industrialized countries isn’t solely a failure of character, according to Princeton University history professor Sheldon Garon, but also of government policy. “Most of the developed world offers restrictions on how much credit can be offered people,” he said. “It’s pretty strictly regulated. And easy credit is inversely proportionate to how much people save.”

In major European countries, he said, the average savings rate hovers around 10 percent and hasn’t dipped for the past 25 years. In Germany, the ubiquitous savings banks won’t offer credit unless they believe that the borrower can pay it off; credit limits can vary widely depending on the banker’s view of the applicant’s financial worthiness and responsibility.

“In Europe, there’s a legal concept of ‘overdebtedness,’ which we don’t have,” said Garon, whose book, Beyond Our Means: Why America Spends While the World Saves, is soon to be published. “In Belgium, if you miss partial payment of your consumer or housing loan over three months, it’s considered overdebtedness, and your name is reported to the Central Bank—which sends social workers to your house to straighten you out.”

Not exactly the American way. “Here, it’s all about personal responsibility—sink or swim,” Garon said. Is this the best way to save people from debt? He cites “empirical evidence that most people exercise financial responsibility poorly. If this was an experiment, it didn’t work.”

The author writes the Short Cuts column for The New York Times and recently published a book, Better by Mistake. She’s at twitter.com/atugend.
Q&A

A Cure: Inflation

For the U.S. economy to recover, now that it’s dogged by debt, Kenneth Rogoff has a novel solution: Print money.

By PAUL STAROBIN

AMBRIDGE, MASS.—Harvard economist Kenneth S. Rogoff has exactly the message that Washington—especially President Obama—doesn’t want to hear: Sorry, there are no quick fixes for America’s economic ailments, and no roaring recovery lurks around the corner. “This is absolutely not like a typical postwar U.S. recession,” he says. It is a severe “contraction” caused by a financial crisis that originated in the housing bust and has mired the nation deeply in debt. So, policymakers need to think outside the box. A little inflation, anyone? Yes, Rogoff advises—as one mechanism to ease the burden on borrowers.

Rogoff, a self-described “Rockefeller Republican,” compels attention. The nation’s entrenched economic woes are confirming the thesis that he and Carmen M. Reinhart laid out in their ironically titled 2009 book, This Time Is Different: Eight Centuries of Financial Folly. A native of Rochester, N.Y., and a teenage chess prodigy, Rogoff is a former staff economist at the Federal Reserve Board and the International Monetary Fund. He speaks with a sober mien that matches his sobering prognosis.

What’s the problem with the U.S. economy?
ROGOFF: There is a big overhang of private debt and, increasingly, public debt. That’s the reason the recovery has been so slow. Ultimately, if we don’t find a way to deal with this, we’re Japan. In fact, maybe we’d be worse than Japan. We could be growing very slowly for a very long time.

What needs to be done?
ROGOFF: One way or another, there needs to be deleveraging—in some cases, debt forgiveness. Creditors are not going to think it is fair, no matter what we do. But the fact is that a lot of the debt on the books today is not going to get paid. Something like 25 percent of mortgages are underwater. A significant percentage of those will end up not being paid in full.

You’ve also advocated “moderate inflation” on the order of 4 percent to 6 percent a year—but you were an inflation hawk when you worked at the Fed back in the 1980s.
ROGOFF: There’s a very strong case that we could use a higher inflation rate right now. It would help stimulate investment, consumption. You’re basically transferring income from high-savings individuals to low-savings individuals.

How would an inflation program work?
ROGOFF: You announce the inflation rate you are trying to achieve, and you essentially print money until it happens. If inflation exceeds that, you rapidly start tightening.

What else needs to be done?
ROGOFF: Deleveraging is going to mean collecting more taxes. The key is keeping marginal tax rates low so people have an incentive to work—but reducing deductions, including lowering the home-mortgage deduction.

With unemployment stuck at around 9 percent, Keynesians would like to see another big fiscal stimulus. What do you think?
ROGOFF: The idea that a giant, debt-funded, fiscal stimulus is the answer puts too little weight on businesses and individuals being worried about their future taxes. If we’re going to spend money to sort of grease the wheels of deleveraging, of mortgage write-downs, I am very amenable to that idea.

Your book argues that countries always think booms will last—that “this time” really will be different. Is America, with its robust doctrine of “exceptionalism,” especially prone to this incautious mind-set?
ROGOFF: The United States is different, but we’re not as different as we think. The idea that [a bust] couldn’t happen was a wrong read of history. If you look at a long enough sweep of history, it is not clear that advanced countries ever outgrow banking crises.

Did economics itself fail in not anticipating the crisis?
ROGOFF: There was this triumphalism in macroeconomics, finance, but the financial crisis has uncovered these huge holes. For my students at Harvard, that is very exciting.

The writer is a contributing editor to National Journal and the author of After America: Narratives for the Next Global Age.
In Perspective

In China’s Debt

The Chinese hold U.S. debt not to hurt an enemy but to help their own poor.

By JAMES FALLOWS

There are lots of reasons to worry about the U.S. economy. But the fact that China holds so much American debt, public and private, shouldn’t be high on the list of concerns.

Let me anticipate two objections. First, the chronic imbalances on each side of this relationship do reflect economic pathologies in both countries. The Chinese government’s long reliance on artificially suppressed consumption, artificially boosted exports, and an artificially high pace of infrastructure building reflects a failure to let its own people enjoy the full benefits of their labor and wealth. And those people, it’s worth remembering, are still only one-sixth as rich, on average, as Americans are. The U.S. government’s long reliance on artificially elevated consumption and an unrealistically low level of savings and capital formation harms the nation’s future and has brought on the deleveraging pressures that are now throttling its economy and the world’s. So even if Chinese holdings aren’t dangerous or destabilizing in themselves, their scale is a symptom of unhealthy distortions on both sides.

And, yes, I will concede that if relations between China and the United States suddenly worsen for some non-economic reason—a dispute over Tibet or Taiwan; a political crisis; a crackdown inside China—then China’s role as America’s banker and landlord could make an unstable situation even more volatile. In normal circumstances, Chinese money managers would have no reason to sell their U.S. holdings in a panic. On the contrary: By starting a run on the dollar as a currency or on Treasury notes as assets, they would destroy their own main international holdings.

But if the two countries moved toward a political or military confrontation, China might wind up using a weapon that would harm everyone involved.

For both of these reasons, China, the United States, and the world economic system will all be better off when the United States relies less on China as a financier and China relies less on the United States as a market.

Exports provide income for China’s urban migrants now entering the middle class.

For them what really matters is supporting the Chinese export-industry machine, which in 20 years has produced jobs for tens of millions of the rural poor who have migrated to a more modern urban life; exports provide income for people now entering the middle class. Closely allied to this goal is the determination to limit the rate at which the Chinese currency rises in value. Left to market forces, the currency would soar, as with any country that runs huge trade surpluses. Although a gradual rise in the yuan’s value since 2005 has increased China’s buying power abroad, authorities are determined to avoid any sudden change that could injure its exports.

The Chinese government has figured out only one way to do this: by taking the surplus dollars that its exporters earn by selling to Wal-Mart, Dell, and a thousand other firms and, instead of exchanging them on the currency market, lending them back to Americans. These loans return as Treasury notes, direct investments in companies, municipal bonds, and other guises that together amount to “America’s debt to China.” But from China’s point of view, their origin is “jobs for people from the provinces.”

It’s a problem for China that it hasn’t done better in matching its enormous output to its own people’s unmet needs. The United States has the opposite problem—that it hasn’t matched its appetites to its means. This is a mismatch, not a plot—but still one that both countries must solve.

The author is a national correspondent for The Atlantic.
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